SUPREME COURT OF THE UNITED STATES.

No. 71.—October Term, 1927.

C. G. Lewellyn, Collector of Internal Revenue for the Twenty-third District of the United States, etc., Petitioner,

vs.

Electric Reduction Company.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third District.

[November 21, 1927.]

Mr. Justice Stone delivered the opinion of the Court.

This case is here on writ of certiorari to the Circuit Court of Appeals for the third circuit, to review its judgment [11 Fed. (2d) 493] reversing the judgment of the district court for western Pennsylvania [8 Fed. (2d) 91], and awarding a new trial. The action was brought by respondent to recover income taxes paid by it for the year 1918. By written stipulation a jury was waived and the case was tried to the court, which made special findings and on them gave judgment for defendant. The principal question to be determined is the right of the respondent, upheld below, to deduct an admitted business loss from its gross income for 1918 in determining its tax for that year, rather than from gross income for a later year.

In July, 1918, respondent contracted with one Jouravleff for the sale and delivery to it in monthly installments of a quantity of tungsten ore. The contract required the buyer immediately to accept a bill of exchange drawn on him by the seller in the sum of $30,000, which was to be applied against the purchase price of the first carload of ore shipped. Respondent accepted the draft and the seller negotiated it through bankers associated with him in the transaction. Respondent paid it at maturity, in advance of any actual shipment of ore, having received from the broker who

had negotiated the sale, a telegram saying: "Shipment one car will be made today." Only a small quantity of ore was ever shipped. This was received in the following December and after being credited upon the amount of the draft left a balance of more than $27,000. In March of the following year respondent began three separate suits to recover the $27,000—one against the seller, the second against the broker as an alleged surety or guarantor of the seller, and the third against the bankers. Judgment secured against the seller in 1919 remains unsatisfied. The suit against the broker resulted in a judgment for the defendant in November, 1922. The suit against the bankers was discontinued in 1921 as useless after they had been adjudged bankrupt. Respondent did not charge off the $27,000 on its books in 1918, but continued to carry it as an item in its "bills receivable" account. It claimed no loss on account of the payment in its tax return for that year. Upon the termination of the litigation in 1922 it filed an amended tax return for 1918, deducting the uncollected balance as a loss, and brought the present suit to recover the alleged overpayment of tax.

Section 234 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1078, provides that in arriving at taxable income there may be deducted:

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

"(5) Debts ascertained to be worthless and charged off within the taxable year."

The district court held that the loss was upon a worthless debt deductible under subdivision (5) and not deductible for 1918 because not charged off in that year.

The respondent contends and the court below held that the loss was not one upon a worthless debt, deductible under sub-section (5), but was deductible when "sustained" under sub-section (4), and concludes that the loss was rightly deducted as of 1918 since the loss was sustained when respondent paid out the money for which it received no return.

We assume without deciding, as was assumed by both courts below, that sub-section (4) and sub-section (5) are mutually exclusive so that a loss deductible under one may not be deducted under the other. We may assume also that upon the abandonment of the con-

tract by the seller the buyer might have maintained an action to recover the balance of the money which he had paid. But so far as appears from the record there had been no abandonment by the seller in 1918. Throughout that period the buyer was calling for deliveries and some were made as late as in December. The buyer's rights were upon a contract for the delivery of merchandise and were not a "debt" in either a technical or a colloquial sense. We conclude that if respondent's contract rights became worthless in 1918 he was not required to deduct his loss as a worthless debt under sub-section (5), but was entitled to deduct it under subsection (4) as a loss sustained in that year.

But we do not think that a loss resulting from a buyer's prepayment to a seller who proves to be irresponsible is necessarily sustained, in the statutory meaning, as soon as the money is paid. The statute was intended to apply not only to losses resulting from the physical destruction of articles of value but to those occurring in the operations of trade and business, where the business man has ventured on a course of action in the reasonable expectation that the promised conduct of another will come to pass. Not only the future success of the business but its present solvency depends on the probable accuracy of his prophecy. Only when events prove the prophecy to have been false can it be said that he has suffered. His case is not like that of a man who fails to learn of the theft of his bonds or the burning of his house until a year after the occurrence; but rather resembles the position of a merchant who buys in one year, for sale in the next, merchandise which shifting fashion renders unsaleable in the latter. It may well be that he whose house has been burned has sustained a loss whether he knows it or not and may recover a tax paid in ignorance of that material fact. But we cannot say that the merchant whose action has been based not merely on ignorance of a fact but on faith in a prophecy —even though the prophecy is made without full knowledge of the facts—can claim to have sustained a loss before the future fails to justify his hopes.

Here the only fact relied upon to show a loss is the outcome of the litigations two years after respondent's payment to Jouravleff. There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reason-

able ground to suppose that efforts to enforce them would be fruitless. On the findings respondent is not entitled to recover.

At the trial respondent offered evidence that it had conducted, in 1918, an investigation which tended to show the irresponsibility of Jouravleff. Inquiries, variously phrased, to elicit this fact were excluded by the trial judge both because they were irrelevant and because the evidence offered was inadmissible as hearsay. An examination of the bill of exceptions discloses that the proffered testimony was rightly excluded on this latter ground. Hence no error was committed by the trial court in its rulings. A trial by jury having been waived in writing, our review in this case is limited to the sufficiency of the facts specially found to support the judgment, and to the rulings excepted to and presented by the bill of exceptions, Rev. Stat. §§ 649, 700; *Fleischmann Co.* v. *United States*, 270 U. S. 349, and we are without power to grant a new trial except for error thus presented. *Mueller Grain Co.* v. *American State Bank*, No. 61, October Term, 1927, decided October 24, 1927, reversing 15 Fed. (2d) 899. The judgment of the district court was right, for reasons other than those assigned by it. It is affirmed, and the judgment of the court of appeals is

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.